

Transforming financial OTC markets.

Struggles around categories.

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Introduction

Lots of research in social sciences and management have highlighted that categorization is crucial to the construction of markets and to how we make sense of the world (Douglas, 1986; Zerubavel, 1991, 1997). Categories impose coherence and create shared understandings (Khair & Wadhvani, 2010; Lounsbury & Rao, 2004). They are considered as instances of commensuration as they provide basis for comparison, commensurability and valuation (Espeland & Stevens, 1998; Zuckerman, 1999, 2004). By influencing perception and interpretation, they act as institutions that facilitate exchange, shape economic outcomes (Khair & Wadhvani, 2010) and the identities and interests of actors (Lounsbury & Rao, 2004; Zhao, 2005). They define social and symbolic boundaries and rules for inclusion (Lamont, 2001; Lamont & Molnar, 2002; Zhao, 2005). When they change, they can significantly alter the nature of the markets in which actors compete. In numerous organizational fields such as mutual fund industry

(Lounsbury & Rao, 2004), automobile industry (Rosa *et al.*, 1999), the stock market (Zuckerman, 2000), art (DiMaggio, 1987), music (Anand and Peterson, 2000), categorization has exerted a great impact on the social structure and social outcome (Zhao, 2005: 196-197). This stream of research not only demonstrates that categorization is socially constructed (Kennedy, 2008) but also develops arguments on its consequences that confer social identities, signify social standing of actors and involve political struggles between different interest groups (Zhao, 2005: 179). Therefore, each categorization has a socio-political origin, reflecting diverse values and interests. More recently, research on categorization has focused on how shared meanings of new market categories are established and how such meanings come to shape collective perceptions of value (Khaire & Wadhvani, 2010: 1281). All these analyses provide insights for our understanding of categorisation from a sociological viewpoint.

Yet, few studies have precisely examined the process by which attempts at categorizing are contested. Some research on change in categorization has primarily focused on factors of durability and argues that powerful actors can preserve the existing structure of categories (Lounsbury & Rao, 2004). While it focuses on the political dynamics of market classification (Lounsbury & Rao, 2004; Zhao, 2005), it has not examined the process and means whereby actors resist attempts to establish categorisation. In this paper, we try to address this gap in the literature by examining the way different market participants resist, promote or adapt to solutions that will potentially significantly alter the definition and the nature of the markets in which actors compete. Our emphasis will be on the use of definitions, standards and categories within controversies. Specifically, this study addresses two research questions about categorical evolution in markets and political dynamics: What are the means by which powerful actors resist categories and contest a certain definition of the market? How do struggles around categories envision a certain meaning of the market (Miller & O'Leary, 2007)?

We address these questions through a case study of the process of OTC market transformation. Following the recent financial crisis, OTC markets undergo unseen regulatory pressure to move from their opaque bilateral transactions mechanism towards a more *walrasian* mechanism where competitive processes would produce more price transparency. More precisely, we analyze the battle over categories involved in the new regulation process. We see the categorization process as a possible instance of commensuration (Espeland and Stevens, 1998) that makes things comparable and

valuable, and allows actors to make a new sense of the world (DiMaggio, 1997; Lounsbury & Rao, 2004). The evolution at stake is contested by various market participants, though. Several issues are on the agenda, namely the migrating from bilateral and manual to multilateral and automated trading mechanisms, the increasing of the use of central counterparties through clearing houses and the improvement of collateral management for the subset of deals that will remain bilateral. In short, the legislative proposal to move as much as OTC markets to exchanges or multilateral platforms as possible, has been met with strong resistance by the major broker dealers.

Our research is based on a qualitative study of the evolution of OTC markets between 2008 and 2011. Our objective is to understand the intentions of the actors, their representation of the market, their metrics, their arguments, and their own interpretation of how regulation will change the market and what they think is desirable. We focus on the type of categories, and standards used or promoted by various market participants; and mainly great investment banks and regulators.

We highlight that resistance is based on the creation of *incommensurables* (Espeland and Stevens, 1998) and on the hyper-instrumentalization of the solutions promoted by the defenders of former conceptions of the market. The increasing technicality of the debate around platforms and categories, and the sophistication of solutions refer to an unquestionable reality that forecloses and neutralises any debate. Additionally, we show that resistance to the new categorization relies mainly on defining the market in a very specific way. The rhetoric used by dominant incumbents is made on an *ad hoc* basis that promotes a specific nature of OTC markets, in very contradiction with the financial theory they were used to promote.

The rest of this paper is in four parts. First, we focus on the theoretical foundation of our research, mainly the literature on categorization, and the political efforts associated with this process. The second part of our paper describes our research method, a longitudinal qualitative study over the period 2008-2011, based on the analysis of secondary data. Next, we study the evolution of OTC market, the struggles around categories and devices and the way powerful actors resist to categorization. In the fourth and final part of this paper, we discuss the main conclusions of our research.

Theoretical background

Categorization as an instance of commensuration

Generally speaking, commensuration is defined as a process through which, different objects, attributes or people are compared, according to a common metric (Espeland & Stevens, 1998: 316–17). It is a way to reduce and simplify disparate information into numbers. Commensuration is a way to standardize relations between different things, to depersonalize and to reduce the relevance of the context (1998: 321).

Some scholars argue that categorization can be considered as an instance of commensuration (Lounsbury & Rao, 2004: 973). According to Kennedy (2003), a category is an exchange referred to by a label whose meaning is a matter of substantial collective agreement by the audiences who use it. As Navis & Glynn (2010: 440) put it, categories have two main properties: 1) constituent members whose inclusion is defined by rules or boundaries pertaining to a common type of product or service and 2) a concept label that reflects the commonalities that link together the members of the category.

Stable shared meanings are indeed essential to the process by which the terms of comparison and commensuration are established (Khair & Wadhvani, 2010: 1283). By listing, classifying and grouping things within a category, commensurability is created, social comparisons are facilitated and, producers and consumers are allowed to make sense of the world (Anand and Peterson, 2000; DiMaggio, 1987; Lounsbury & Rao, 2004: 974). Using a case study of law schools, Espeland and Sauder (2007) explain, for example, why rankings have permeated the legal education system, how they change perceptions, and how they “recreate social worlds.” This process has an important rhetorical aspect (Carruthers and Espeland, 1991), and requires significant resources and organization. Additionally, some instances of commensuration help to constitute what they want to measure. For example, grading systems create explicit categories of relative quality and hence relative value that make possible trade in products that may not yet exist (Cronon, 1991; Espeland & Stevens, 1998; Porter, 1996). Hence, categorization is essential to commensuration and market construction. It provides “rules and understandings that are necessary to make structured exchange possible in the first place” (Fligstein, 2001: 32). As Lounsbury & Rao (2004: 973) note, the very idea of markets depends on standardization and the comparability of the objects being exchanged

(Douglas & Isherwood, 1979). Categorization supplies cognitive frameworks (DiMaggio, 1997), and defines boundaries (Khaire & Wadhwani, 2010; Lamont, 2001; Lamont & Molnar, 2002). These latter present or confirm a social order with specific meanings and legitimacy (Zelizer, 1988; Zhao, 2005: 187). To wit, categorization organizes information, generates shared understanding, affects valuation and finally, facilitates exchange in market settings (Espeland & Stevens, 1998; Khaire & Wadhwani, 2010).

Sometimes categorization and standards of value are redefined or reconstituted (Lounsbury & Rao, 2004) and involve a transformation of markets. Building on Zelizer (1983), Quinn (2008) describes for example the changing secondary market for life insurance in the United States. She shows that the evolution in product categorization has radically modified the market for life insurance and how it has grown from “a scattered practice” (sacred revulsion) into a rationalized field (rationalization). Other scholars highlight that sophisticated forms of commensuration and categorization have really transformed financial markets (Espeland & Stevens, 1998: 325-6). In this perspective, Kennedy, Lo and Lounsbury (2010) argue for a vision of market categories as the vocabulary for describing a demand environment that is always changing and where the landscape of competition is at stake.

Categorization and commensuration are not inevitable, however. As social processes (Desrosières, 1990, 1998), they require lots of work and effort to accomplish, since they integrate disparate value systems or different interests, reconfigure them and somehow change the world (Stevens & Espeland, 2004). As categorization involves not only “framing” (Callon & Muniesa, 2005), that is, a definition of what a market transaction formally includes, but also an interplay between different actors with potentially different worldviews, we argue that categorization is a contested political process.

Categorization as a contested political process

Commensuration and categorization are modes of power and they are highly political (Espeland & Stevens, 1998; Lounsbury & Rao, 2004) as they reconstruct relations of authority, create new entities and establish new interpretive frameworks (Espeland and Stevens, 1998: 323). Selection of a particular category by social actors is a political action (Albert & Whetten, 1985), it is negotiated between interest groups and the final

categorization system is often the result of political struggles between them (Zhao, 2005: 191). Attempts at manipulating the categories to maintain order and to consolidate their position by dominant groups highlight that categorization is shaped by the politics of markets (Fligstein, 1986; 2001) and is driven by political dynamics. Lounsbury & Rao (2004) examine for example the role of industry media and powerful producers in category evolution in the American mutual fund industry. They emphasize that when powerful producers dominate a category, they can counteract the influx of new entrants and encourage industry media to preserve the existing structure of categories. Overall, dominant incumbents always strive to claim the desirable categories in order to signify and consolidate their standing (Zhao, 2005: 188-191). They often take advantage of economic, political and cultural resources (Bourdieu, 1984) to control the categorization system. As Zhao (2005: 193) illustrates, in the French wine industry, the categorization system embodies the political power. The 1855 classification of Bordeaux wines was indeed controlled by elites winemakers to protect their own interests and to exclude other winemakers.

Sometimes, actors resist commensuration and categorization. One strategy can be to create what Espeland & Stevens (1998: 332) call *incommensurables*; between children and money, for example (Zelizer, 1985). This process requires work and draws boundaries around the things whose value is to be kept. The most frequent and durable claims about incommensurability occur at the borderlands between institutional spheres, where different modes of valuing overlap and conflict (Espeland, 1998). Categorization can also be contested because of the loss of elite discretion that it fosters (Espeland & Stevens, 1998: 330). The legitimacy offered by numbers and standardization diminishes autonomy, since discretion is replaced by disciplined methods: “This is why quantitative technologies are the province of weak elites and why they are resisted by those whose authority depends on expert judgement, character or informal knowledge” (Espeland & Stevens, 1998: 331). In his history of quantification, Porter (1996) shows for example that insurance was originally seen as a local problem. Actuaries believed in their subjectivity, their own expert judgment and appreciation. However, while Victorian actuaries did not really believe in the possibility of standardization, and of reducing their work to calculative routines, the push for “objectification” came instead from regulatory authorities. Historically, the process by which idiosyncratic risks are pooled to be handled homogeneously appears unnatural and occasionally requiring strong state intervention.

Then, the success of categorization may depend on an “intrusive institutional apparatus” and specific organizational activities (Carruthers and Stinchcombe, 1999). As standardization is a socio-political achievement, the role of the State can sometimes be central to catalyze homogenization and commensuration.

To wit, the political nature of categorization (Lounsbury & Rao, 2004; Zhao, 2005) and the idea that categories are products of practical political processes (Zuckerman, 1999) are henceforward acknowledged in the literature. But few studies precisely examine the process and means whereby actors resist categorization. While Espeland & Stevens (1998: 323) note that “we are more likely to notice failure of commensuration than its widespread varied success”, we think that we need to explain more precisely how people contest categorization (Espeland & Stevens, 1998). We focus on the means used by dominant incumbents to resist categorization and we answer two main research questions: What are the means by which powerful actors resist categories and contest a certain definition of the market? How do struggles around categories envision a certain meaning of the market?

We believe that the current regulatory pressure on the OTC markets offers a unique opportunity to conduct insightful investigations to understand the role of the struggle over meaning construction in the definition of modern financial markets and to gauge the power of the actors involved according to their ability to alter or resist categorization.

Methodology

The setting of our study is OTC markets in the light of recent regulatory change. Our research is based on a qualitative study of their evolution between 2008 and 2011. Our objective is to understand the intentions and beliefs of the actors, their representation of the market, their metrics, their arguments, and their own interpretation of how regulation will change the market and what they think is desirable. We focus on the type of categories, language and standards used or promoted by various market participants; and mainly great investment banks and regulators.

We chose this case because it provided several benefits as a “theoretical sample” (Eisenhardt and Graebner, 2007; Khair and Wadhvani, 2010). The time period we cover

in the case includes a crisis and a regulatory evolution, which is best illustrated by attempts at introducing a change in the way OTC markets are categorized. It was then possible to analyze how main actors of the market, and particularly big banks make sense of categorization and how they accepted it or not. Besides, our case provides a good illustration of the resistance to change, which is embodied in the struggles around categories, and mainly on the struggles over the definitions of products and markets. Finally, this case is particularly appropriate for our demonstration, because due to the recent crisis and to different public initiatives, banks, experts, regulators, and media do not hesitate to express themselves, to give their views on the contributions and limitations of future developments, through a large number of texts.

Sources of data

Our objective is to offer a description of OTC markets and its recent evolution, its instruments and devices, in order to improve our understanding of our object. In the second stage, we attempt to put forward the views and types of arguments that agents use when debating. To reach these objectives, we used multiple sources of empirical evidence, and mainly textual sources, which can be divided into three main categories.

Archival materials. We consulted many categories of archival information (reports, white papers, studies of the Bank of International Settlements or IOSCO¹.) to better understand the context of OTC markets, to confirm the main recent events in these markets, and also to provide textual accounts of debates and discussions. We also studied information, texts, and discourses stemming from main actors' websites around new devices, such as ISDA² or Tabbgroup³.

Mifid-consultation. We have analyzed contributions to the public consultation organized by the European Commission on the basis of a consultation document on the review of the Markets in Financial Instruments Directive (MiFID) from 08/12/2010 to 02/02/2011. The consultation's purpose was "to consult market participants, regulators and other stakeholders on possible changes to the regulatory framework established by MiFID in the field of investment services and activities as well as markets in financial instruments".

¹ International Organisation of Securities Commissions

² International Swaps and Derivatives Association

³ Founded in 2003, TABB Group is a financial markets' research and strategic advisory firm focused on capital markets.

It resulted in more than 4200 responses, which are supposed to “provide important guidance for preparing a formal Commission proposal”. A careful analysis of these responses provides interesting results, in particular as regards the globally adverse position of main investment banks towards the regulation to come and the means they use to resist against unwanted change. Knowing that these large financial institutions are at the core of OTC markets and are involved in the majority of the deals struck on these markets, the consultation responses provide a rich database to observe resistance to the new regulation and to study the arguments used for that purpose.

Press articles. To review press articles, we used the Factiva database, which provides business news collected from 14,000 sources. The articles were chosen from 2008 to 2011. In total, 150 articles made up our database, beginning with research on the terms “OTC markets” and “regulation”. From these documents, we are able not only to reconstitute main events, but also to focus on the representations and discourses of different actors regarding OTC markets and its recent evolution regarding regulation.

Data analysis

Our analysis was conducted in several stages. Following Miles and Huberman (1994) and Yin (1989) and building on press articles, we first arranged the data into chronological account in order to produce a “facts database”. We identified the main actors and events in the evolution of OTC markets from 2008 to 2011. We then tried to capture the “justificatory accounts” of the different actors (Greenwood and Suddaby, 2006; Huault and Rainelli, 2009) engaged in OTC markets and its evolution. We focused on an initial set of narratives stemming from the Mifid-consultation, reviewed them carefully and interpreted the data to point out three main fronts in the resistance of banks to any change: 1/ struggles over the definition of the products, 2/struggles over the kinds of electronic venues, 3/debates about the boundaries of the market and more precisely, regarding who is a legitimate participant to take part to the market. We used then the other data sources to verify these different recurring themes.

Resisting categorization

Faced with political pressure and public opinion's wrath in the aftermath of the subprime crisis, regulators and public authorities of developed countries have taken spectacular though yet only preliminary steps toward the regulation of OTC derivatives markets. While the size gained by these markets and the growing dependence of the whole financial sphere on their functioning had remained unnoticed for years, the subprime crash suddenly shed a crude light on a form of markets which had been tending to become dominant in modern finance (Huault & Rainelli, 2011). The lack of academic as well as non-academic knowledge over these markets became obvious in the favor of the crisis. Ignorance of the most basic characteristics of OTC markets such as their actual size, the exact number and nature of players, the number of transactions involved, the price quoted, or the liquidity of the market came to be recognized as a problem. This may explain why, in a collective move, regulators of both side of the Atlantic have adopted a regulatory approach favoring the displacement of as many as possible OTC transactions onto organized markets. They see it as a means "to tackle less regulated or more opaque parts of the financial system and to improve the organization, transparency and oversight of all market segments"⁴. The philosophy of regulations to come has been sketched in the Dodd Franck Act for the US. It is still under CFTC⁵ consultation. As for Europe, the project is developed mostly in the so-called MiFID 2, also under European Commission consultation. In both cases, the main axis hinges on the idea developed under the September 2009 G20 summit that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest."

Building on this idea, the proposed reformed MiFID aims to ensure that "where appropriate, trading in standardized OTC derivatives moves to exchanges or electronic platforms". It considers that "at a minimum, this would imply that trading on exchanges and electronic platforms becomes the norm when the market in a given derivative is suitably developed". In this paper, we propose to analyze contributions to the public consultation organized by the European Commission on the basis of a consultation document on the review of the MiFID. We aim at understanding the battle over

⁴ MifiD Public consultation document 2011

⁵ Commodity Futures Trading Commission

categories involved in the process by which regulators attempt to translate general regulatory principles into implementable regulation. As a matter of fact, the G20 injunction cannot become embodied in a given piece of legislation, lest ambiguity about what is meant by “when appropriate”, “standardized OTC derivatives”, or a “suitably developed market” is alleviated. The resistance opposed by incumbent firms, namely big investment banks, which deem they have a lot to lose in the transformation of OTC markets into organized market, therefore firstly focuses on a contestation over the categories proposed by the legislator. These categories especially regard the definition of products falling in the scope of the legislation to come and the regulatory regimes of the platforms proposed by the regulators. Second, dominant investment banks also struggle to maintain social boundaries between their high status group often referred to as market specialists and other actors, which access to the post regulation market incumbent firms try to control. Third, the struggle over categories and social boundaries as it appears in the contributions to the MIFID consultation seem to require from various interest groups the capacity to resort to pieces of cultural material, by which the concepts used as matrix for categorization can be granted or, on the opposite, denied legitimacy. Our analysis sheds light on the relevance of cultural repertoires in the categorization battle and assesses their importance as regards the regulation of financial markets.

Creating Incommensurables

Struggles over the definition of products

According to the proposed MIFID regulation in its most general labeling, the guideline is that, once it is adopted, all “eligible” OTC derivatives should be cleared via central counterparties and move to organized platforms. The regulation thus proposes no less than the transformation of OTC contracts -mere contracts which terms have been agreed upon by the counterparties to the deal- into deals that could be exchanged on a market, very much as stocks are on equity markets. This transformation should take place, “where appropriate”, “when a market in a market derivative is suitably developed”, and it should concern all “standardized OTC derivatives”. As all these expressions require further definitions, investment banks devote much of the space they use to answer the consultation to contesting definitions in the proposed regulation and developing arguments towards the categorizations that they would deem preferable.

The ISDA for example provides extensive development on the difficulty of defining which OTC products would be “suitable”, or “eligible” to specific pieces of regulation. First, ISDA advocates,

“The assessment of whether a derivative is suitable for trading on a particular trading venue should be made separately to the assessment of its eligibility for central clearing”.

As regards trading on a venue, it seems that standardization of the product would not provide a clear-cut criterion as opposed to the regulator assertion:

“It is not always appropriate for derivatives trading to take place on organized trading platforms even if transactions have been become relatively standardized in some respects”.

and

“A contract might exhibit the necessary standardization for clearing, but nonetheless be unsuitable for trading on a particular venue, whether Regulated Market, MTF or OTF.”

Liquidity does not seem to provide any better criterion, as

“derivatives trade far less frequently than securities, such that many products will not be suitable for trading on a particular venue”.

Moreover “a liquidity criterion would be difficult to administer in practice” and the ISDA urges regulators, if they stick to the idea of using a liquidity threshold as part of the assessment of whether a product should be traded on a venue, to be aware that the exercise would be fraught with difficulties. The threshold they insist should be:

“set at a realistic level that differentiates between products, capable of being calculated and predicted, subject to periodic review and able to accommodate temporary changes in the market”.

As for contracts eligible for clearing, the situation is by no way simpler: one will have to distinguish between eligible and non-eligible contracts and stay aware that some contracts may “cease to be eligible”. Complexity provides no more useful benchmark for the design of categories, as, as is several times emphasized in the ISDA, BBA⁶ and other investment banks responses,

⁶ British Bankers Association

“a false link is sometimes made between product complexity and product risk, which leads to the illusion that complex instruments are automatically high-risk instruments”.

The same example, described at length in many banks’ responses, aims at demonstrating how in OTC derivatives markets, product complexity is often the result of products being designed to reduce client’s risks, and therefore do not call for specific risk protection through clearing.

Overall, the arguments developed seek to undermine the categorization proposed in the piece of legislation by depicting them as irrelevant and/or impossible to implement in practice. The various criteria provided by the levels of standardization, liquidity or complexity are presented as not operational, creating a sense that the categorizations proposed by the regulators do not fit OTC products, although no alternative is proposed by institutions resisting the new regulation.

Struggles over electronic venues’ regime

Besides the debate on products definition, a second front is opened by the proposed regulation as regards the kind of electronic venues on which OTC products could be exchanged. Since MiFID 1 in Europe, financial instruments can be exchanged either on a traditional stock exchange, called Regulated Markets -or RM- in the proposed piece of regulation on or electronic platforms called multi-lateral trading facilities (MTF), which since 2007 tend to take significant market share from the incumbent equity exchanges. MTF allows eligible contract participants to trade a variety of securities, via electronic systems operated by market operators or large investment firms. In addition to having the obligation to establish “transparent and non discretionary rules for fair and orderly trading⁷”, MTF shall answer pre trade and post trade transparency requirements. In particular, they should make public current bid and offer prices and the depth of trading interests at these prices, except for orders of specific size or type and have, in this respect the same kind of obligations as regulated market, “except where justified by the specific nature of the MTF”. As regards post trade transparency, MTF have the obligation to make public the price, volume and time of the transactions executed under their systems, with possible exemptions that have to be justified. Requiring that OTC derivatives move

⁷ Mifid 1, art 14

to electronic platforms raises an issue as to whether the MTF “regime”, with its post trade and especially pre trade transparency obligations is suited for the kind of products usually exchanged OTC. Regulators themselves seem to be ready to admit it might not and propose the creation of platforms of another type, called SEF (Swap Execution Facilities) in the US proposed reform, and OTF (Organized Trading Facilities) in the European Commission Proposal. The debate then focuses on the transparency requirements that will be asked from OTFs. While post trade transparency entails limited debate, - no one expects OTC markets to be able to durably get away from that obligation-, pre trade transparency, on the opposite has become the issue. The MiFID proposal is that venues “would be required to make its quote both in terms of price and volume available to the public”, suggesting that the OTF regime is not meant to be significantly different from the MTF regime in terms of transparency obligations. This however seems amendable in the view of many regulators. The AMF for example suggests a distinction between a sort of “supra-OTF regime” for which:

“requirements (governance/organization, multilaterality, pre-trade transparency etc..) should be very demanding, and “regular” OTFs, primarily aimed at trading in less liquid financial instruments”.

In a long and circumstantiated report, the IOSCO concludes to the necessity of using both more structured and less structured platforms, according to the liquidity of the derivatives products targeted.

Overall, the September G-20 statement, according to which all standardized OTC derivatives contracts should be traded on exchanges or electronic trading platforms, where appropriate, results in a blossoming of definitions of platforms of all kinds, reflected in the multiplication of acronyms (MTF, SEF, OTF), regimes (the AMF speaks of a supra and of a regular regime for OTFs) and characterization (more or less structured along various dimensions, with special focus as regards pre trade transparency requirements).

Opponents to too stringent a regulation, for their sake, attempt to push their demand of as little constraint as possible as much as they can. The ISDA for example insists that the OTF regime must protect the existing diversity of models for negotiating and executing derivatives transaction. It warns that “if the OTF regime is inflexible in its design and/or promoted too aggressively for products currently traded OTC”, -meaning if

the OTF's regime requires stringent pre trade transparency-, then the market would concentrate into a narrower range of products, hampering market participants to manage risks appropriately and conducing to loss of market efficiency.

The fact that the legislative proposal to move OTC markets to multilateral trading venues has been met with "more resistance from the major dealer community, than any of the other (financial regulation) proposal" is, according to authors of the January 2010 Tabb report, no wonder. Emphasizing

"the resistance to adopting any mechanisms that attempts to pierce the veil of opaque pricing currently enjoyed by major dealers"

experts of the Tabb Group point to the comfortable economic profits allowed by the absence of any pre-trade transparency on the current OTC voice market paradigm and estimate that there is

"as much as 40\$ billion of annual revenues (excluding credit derivatives) at stake in global OTC derivatives for the 20 largest broker dealers".

As compressed margin and threatened profitability are seen by incumbent banks as the likely result of the proposed reform, one understands their efforts in contesting the legislative proposal requiring investment firms executing trades OTC to provide "quotes to a large number of investors at a price close to market value from comparable instruments traded on organized venues".

While a large investment bank contests the principle itself:

"In general terms transparency in markets can help to build confidence, by ensuring that participants have access to information. However, there are products and markets, which are so illiquid, that revealing trade information could actually be detrimental to buyers and sellers. We have to balance the benefits of transparency versus the potential downsides". (Citi- Mifid consultation)

the ISDA grasps the opportunity to discuss that particular point by developing sophisticated definitional issues. Contesting the term "quote", for at least the more structured (in other words less standardized) products, the ISDA proposes that the price of OTC derivatives is seen as a price for a "solution", which can "take weeks, if not months to finalize". Highly bespoke products have "by definition no benchmark price" and apparently identical products might differ in prices according to the "perceived creditworthiness of the counterparty":

"A price will always reflect the situation at the time it is made and therefore will not necessarily be comparable".

The notion of quote is thus not relevant as regards bespoke products and pre-trade transparency is inadequate to most OTC products.

On the whole, as regards the definition of venues on which OTC derivatives will be exchanged in the future, the struggle of major investment banks against pre-trade transparency obligations consists in demanding flexibility while creating as much complexity and sophistication as possible to resist unwelcome evolution. This results in a multiplication of acronyms and definitions reflecting a strategy to hamper the drastic change in the status quo involved in the regulation to come and perceived by major dealers as a threat to their profits.

Maintaining social boundaries and status

In the political struggle over the regulation to come, products definition is not the only issue at stake. Among other things, the 2009 crisis has revealed the very high concentration of OTC markets, where a group of large investment banks tend to be involved in most transactions (Huault & Rainelli, 2009; European Central Bank report, 2010). These major dealers, sometimes referred to as the G14 or G15 group⁸, have been working hard in creating, structuring and organizing OTC markets (Huault & Rainelli, 2009) and are therefore eager to defend the paradigm they created against the regulators' will to change the rules of the game. In this paradigm sometimes depicted as "a market for specialists", major dealers, according to the Tabb Group report "represent a hermetically sealed wall of opaque pricing between a wholesale dealer-to-dealer market and a buy side oriented, dealer-to customer market". Enjoying high status and reaping important economic benefits from the status quo, the G14 members therefore aim at maintaining social boundaries, trying to secure access to the post-regulation derivatives and control that of lower status actors. This social boundaries issue is tackled directly in the contributions to the MifID consultation. It also emerges in the related issue of the

⁸ This includes the following banks: Bank of America-Merrill Lynch, Barclays Capital, BNP Paribas, Citigroup, Commerzbank AG, Crédit Suisse, Deutsche Bank AG, Goldman, Sachs & Co., HSBC Group, JP Morgan, Chase, Morgan Stanley, The Royal Bank of Scotland Group, Société Générale, UBS AG, Wachovia Bank.

creation of clearing houses, which is not directly debated in the proposed MiFID legislation.

The reluctance from large investment banks to change in the status quo as regards the role of market specialists is illustrated for example in this contribution to the MiFID consultation:

“Finally, one should keep in mind that the more transparent the markets, the more difficult it would be to limit their access to all sorts of investors. It may not be wise to let retail investors feel as if it would be good for them to invest in derivatives instruments because they are traded on an exchange (or trading platform)” (ABBL Bankers Luxembourg- Mifid consultation).

The debate on who should be allowed to participate is also especially exacerbated as regards one reform which is not at the core of the MiFID revision and was envisioned by the regulators prior to it: the creation of clearing houses to clear “eligible” OTC products. Although the establishment of clearing houses is not altogether welcome by incumbent banks, they are aware that this development can be turned into a profitable opportunity, provided they secure their access as members of the clearing houses and keep challengers outside, in order to avoid sharing profits from clearing activities with them. While the CFTC Chairman advocates eligibility requirements that promote large inclusiveness, to enable fair and open access to clearing, investment banks struggle on restricting the number of those who will be allowed to participate in clearing houses. Embracing some views like Darrel Duffie⁹’s, professor at Stanford, according to which it will be hard for the dealers to keep their market shares if every investment firm who can prove its creditworthiness is allowed into the clearinghouses, large investment banks try to establish strict membership rules that require members to hold large amounts of capital in derivatives units. Deutsche Bank argues for example that this system will reduce the risk in the market.

By attempting to control clearinghouses, great investment banks probably hope to be able to influence the decisions of which transactions must be cleared and which do not need to. The ability of the major dealers including JP Morgan Chase, Goldman Sachs and Morgan Stanley to protect their position and margins is well known and their attempt to control the clearing-house business is but one example. Already dominating the risk

⁹ Source: Louise Story, New York Times, 12/12/2010

committees of the two most important existing clearinghouses in the United States, they are referred to by critic voices as “the derivatives dealers club”. As Louise Story from the New York Times writes¹⁰, they meet on the third Wednesday of every month and form a powerful committee, which aim is to protect their dominance as a high status group over a multi-billion dollar market. As regards clearing houses for derivatives however, they are challenged by non-incumbent firms who protest that the exchange’s requirements proposed by major dealers, by drastically limiting participation to member of the club, are purely prohibitive. In reaction to the Bank of New York Mellon case, where a smaller stakeholder was kept from becoming a clearing member of three of the four main clearinghouses on the argument that its derivatives operation has too little capital, and thus potentially poses too much risk to the overall market, a new association called the SDMA¹¹ was created. Presenting itself as challenger to the ISDA, the SDMA advocates the opening of clearing to more participants. Constituted of approximately twenty independent firms, it argues against the requirements as arbitrary and acting as an “anticompetitive weapon”. The SDMA asserts the more members in a clearinghouse, the more liquidity available in case of a clearing member failure:

"There's a constant need for alternative providers of liquidity and market intelligence... More liquidity will lower transaction costs, increase transparency and protect customer anonymity." (Mike Hisler, partner at investment bank Hexagon Securities, and member of the SDMA)

Overall, beyond struggle on product and trading venues categorization, resistance to legislation from major dealers also take the form of defending social boundaries between their high status group or club and non-incumbent firms in an attempt to preserve the status quo as much as possible. The economic paradigm they have organized and structured has provided them with large economic profits they fight to preserve by both resisting new regulation and trying to influence it so that important features of the status quo such as social boundaries between major players and others are ultimately maintained in the new rule of the game.

¹⁰ “House advantage. A secretive banking elite rules derivatives trading”, *New York Times*, 12-12-2010

¹¹ Swaps and Derivatives Market Association.

Discussing market nature

Generally speaking, the typical attitude of major investment banks towards the proposed regulation of OTC derivatives market is one of seemingly systematic resistance against change. This reveals a more fundamental and general disagreement with the regulator as regards the relevance of being forced to create a new market structure to replace the former OTC one. The general perspective of the proposed regulation tends to corner incumbent firms in a defensive position, where their arguments ultimately aim at maintaining the status quo as much as possible. As the regulators' proposal is that "all standardized OTC derivative contracts should be traded on exchanges or electronic trading platforms, where appropriate, and cleared through central counterparties by end-2012 at the latest", opponents to the reform have to develop a conceptual line of reasoning showing that the traditionally desired feature of exchanges such as product standardization, liquidity or price transparency are unwanted on up-to-now OTC markets. The lack of knowledge on OTC markets (How liquid are in reality these markets? How much standardized are bilateral deals?) is a handicap in the development of their argument, but a further difficulty is the absence of any conceptualization of what a "specialists" market is, what it should be and what features should be developed for such a market to function satisfactorily. On the opposite, neo classical financial theory, which provided the matrix for most of the innovations traded on OTC markets (Huault and Rainelli, 2010) has heavily conceptualized on financial market efficiency providing a unique view of ideal financial markets, very much inspired by the walrasian auction market model, which happens to be at odds with OTC markets (Huault and Rainelli, 2011). Major dealers therefore are faced with the difficulty of having to combat a widely shared theoretical vision of proper financial market functioning without any possibility to draw alternative arguments from existing conceptualizations. Dealing with this void is not an easy task. The recurrently emerging argument about the "nature" of OTC markets, allegedly different from standard equity markets on which regulators want to align them, illustrates this difficulty, especially as no precise definition of what is meant by this concept of "market nature" succeeds in materializing.

In opposition to regulators such as the SEC Chairman who would like derivatives rules to reflect the virtues of the current equities market, *i.e* competition, large access,

liquidity and transparency¹², banks repeatedly contend that OTC markets belong to a different species of market, and obey to a qualitatively and structurally different logic.

“We are concerned that the approach proposed does not fully take into account the *nature* of the OTC derivatives market. We feel it is essential to understand that execution mechanisms for OTC products must be appropriate” (Deutsche Bank-Mifid consultation).

“There have not been, to the best of our knowledge, any serious academic studies demonstrating that the transposition of the equity model to OTC derivative products will be economically more efficient than the current trading model”. (BNP-Paribas- Mifid consultation)

Forcing OTC markets to adopt a structure that is not “appropriate” because it does not respect their nature is depicted as potentially very detrimental for the common good and likely to generate unwanted results as regards the very aim of the regulators:

“Efforts to centralize and standardize OTC trading could:

- Harm the EU market as a whole - investors cannot get the specific solutions they seek and this may, in turn, have an effect on the services they provide ;
- Lead to an actual increase in systemic risk on account of restrictions in OTC trading (and the ability of market participants to hedge);
- Harm the reputation of the EU as a financial centre with innovative and sophisticated products being traded out of Asia instead”. (Crédit Suisse- Mifid Consultation)

"By moving OTC products onto exchanges, we would expect to see a reduction in liquidity that may negatively impact the sought-after price transparency," (Bruce Collins, deputy chairman of Tradition, an interdealer broker based in London). Source: *Dow Jones Newswires*, 14-5-2009)

“Too much transparency will create cost, noise and, as discussed, could have a negative impact on market liquidity, in particular for large OTC trades”. (Deutsche Bank- Mifid Consultation)

Two arguments are used to support the idea that too much attack on the status quo would eventually prove harmful. One is naturalistic in that it emphasizes the fact that the current structure of OTC markets and products is a response to client needs; well adjusted to what is demanded, it should not be put in question. The chief lobbyist of the ISDA, for example, judges that excessive standardization might only encourage speculation, and will not contribute to anything positive, while custom-made products answer the needs of enterprises and investors. Similarly, according to Bank of America Merrill Lynch:

“there are many reasons why clients prefer to trade derivatives OTC in certain circumstances, including pricing, confidentiality and operational ease. We do not believe that reducing this

¹² Source: *Financial Times*; 23.9/2010

consumer choice will represent a positive development for the market.”

Second, the nature of OTC products, which are bespoke, and involve infrequent, long lasting, large transactions render them very suitable to specific financial strategies. Upsetting the market structure for these products will make these strategies useless, at the detriment of what major market actors do not hesitate to call market efficiency. The WMBA¹³ for example says moving OTC instruments onto exchanges could increase risk by limiting companies' ability to tailor hedges to suit their needs. Within the Mifid-consultation, several banks concur to this view. For Goldman Sachs, mandating standardized products could limit a market participant's ability to hedge, leaving it exposed to risk, and potentially a loss of hedge accounting treatment. The British Bankers Association develops the same argument along the following line

“It is also important to understand that the main use of the OTC FX market is to allow corporates to hedge future exposures. They therefore require an ability to trade against specific dates or to cover specific, changing circumstances. Because of the bespoke nature of these transactions it is crucial that the dealer market retains the ability to trade with each other in a bespoke manner. Failure to do this will lead to significant risk mismatch and large P&L swings”.

On the whole, in their defense of the status quo on OTC market structure, major dealers are entailed to develop views that contradict usual financial wisdom. According to them, fully transparent price competition is not desirable on OTC markets, standardization is not a means to improve liquidity, absence of liquidity is in the same time minimized if not denied and depicted as a given on these type of markets. To articulate these views, which are heterodox as regards standard financial theory, major dealers are cornered to invoke a specific nature of OTC markets, which they have difficulties to define convincingly. They lack an alternative conceptualization of efficient financial markets beyond the traditional *walrasian* paradigm. This raises a question over the extent to which this theoretical deficit is likely to constitute a significant handicap for major dealers in their struggle against regulation or not.

¹³ Wholesale Market Brokers Association

Conclusion

The regulatory change planned to transform financial OTC markets into organized markets provides us with an opportunity to study the processes and the means by which powerful actors resist categorization and contest a certain vision of the market. Undermining the categories proposed by the regulator, and arguing they are either irrelevant or impossible to implement in practice, major dealers devote a great time and energy creating incommensurability. Their battlefield is twofold: first, they debate on product categorization and second, on platforms or venues categorization. This results in a blossoming of definitions and a multiplication of acronyms, conveying the notion that the matter at stake is highly complex and the regulation will be difficult to implement in practice. Beyond the creation of incommensurables, major dealers directly attempt to defend social boundaries and protect the “clubby” nature of OTC markets. Their aim here is to control the access of other market participants and defend their status by imposing conditions that would result in preserving the status quo. Overall, the struggle against the regulation to come is a struggle over a market form. This is the reason why contesting the regulator’s view that OTC markets can easily become organized markets, incumbent banks are cornered to develop the notion of a specific nature of OTC markets. However, they lack the conceptualization allowing for a precise definition of this nature. This raises the question of how they can overcome this weakness in their argumentation against regulation.

Our paper contributes to the literature devoted to the political nature of categorization (Lounsbury & Rao, 2004; Zhao, 2005) and the idea that categories are products of political processes. We concur with Lounsbury and Rao (2004) in providing evidence that, facing unwanted change, incumbent firms struggle for categorization’s status quo. We argue their efforts can be interpreted as an attempt to build incommensurability. This process cannot be taken for granted (Desrosières, 1990; Healy, 2004) and requires work (Zelizer, 1985; Porter, 1996). Two main features can be highlighted as regards the struggle over categorization in our field. One is the role played by the hyper-sophistication and technicity of the debate, which serve as a veil in the debate between the regulation pros-and-cons. The use of acronyms, the contestation of categories, the multiplication of definitions are used by incumbent firms to convey a vision where the present social order is too complex to be easily transformed. The other feature is the part

taken by theory – here financial theory- as a cultural repertoire for parties at stake in the debate. As the legislative attempt heavily relies on standard theory and draws its legitimacy from it, dominant actors, in their struggle against change, are forced to advocate its irrelevance as providing solution to remedy the issues targeted by the regulator. They find themselves having to resort to some *ad hoc* defence, which let them devoid from the traditional legitimate cultural repertoire. This raises the question of the role this weakness is likely to play in the struggle over regulation. To what extent will major actors which resources in economic power and lobbying capacity are huge, be handicapped by the lack of legitimatizing theoretical and cultural apparatus? The answer to this question partly depends on whether the debate occurs in a regime of justification as opposed to a regime of domination (Boltanski and Thévenot, 1991/2006; Boltanski, 2009). As we showed elsewhere (Huault and Rainelli, 2011), one can suspect that, over the recent period, financial actors have been engaged in domination rather than justification processes, exerting their capacity to “restrict critical space” (Boltanski, 2009: 176) and not having very much to align discourse and action. Hyper-instrumentalization and ultra-technicality of financial markets have allowed them to set game rules and prevent external actors, from intervening, criticising and debating, pushing the financially uninitiated further and further from any democratic decision making. The question of the relevance of the strength of the cultural repertoires at stake, which emerges in our field is thus heavily related to the question of whether the regulation wave will force major actors of the financial markets to enter in a regime, new to them, where they have to justify and legitimate their actions much more than they used to.

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